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Date: JUNE 21, 2006

Legend

Trust 2 =

Daughter =

Mother =

Son =

Granddaughter 1 =

Granddaughter 2 =

Grandson =

Date 1 =

Date 2 =

Date 3 =

Year 1 =

Year 2 =

Bank =

A =

B =

C =

D =

E =

x =

a =

b =

c =
d =
e =
Court =
State =
Citation =

Dear :

This is in response to the June 20, 2005 letter and subsequent correspondence, submitted on your behalf by your authorized representative, concerning the generation-skipping transfer (GST) tax, gift tax, and income tax consequences of the proposed termination of a trust.

The facts and representations submitted are summarized as follows: Daughter executed an irrevocable trust agreement, Trust 2, dated Date 1, which is prior to September 25, 1985. Trust 2 was created for the primary benefit of Settlor's mother, Mother. The current trustee of Trust 2 is Bank.

Pursuant to Paragraph 3(a) of Trust 2, after the death of Mother, if there shall then be living any issue of Son other than Grandson and Granddaughter 2 and their issue, the trustee shall divide the net rents, profits and income of Trust 2 at least annually, and more often in the discretion of the trustee, into as many parts as there shall be children of Son living, and deceased children of Son leaving issue living at the time of such division, other than Grandson and Granddaughter 2 and their issue. The trustee shall pay over one such equal part to such living issue, per stirpes, of any such deceased child (other than the issue of Grandson and Granddaughter 2). The trustee shall pay over one such equal part to each of such living children (other than Grandson and Granddaughter 2), or, in the uncontrolled discretion of the trustee, permit such income to accumulate in whole or in part. Mother died in Year 1. Daughter died in Year 2. Accordingly, Granddaughter 1 is the current income beneficiary of Trust 2.

Upon Granddaughter 1's death, the trustee shall transfer, deliver and pay over the amount theretofore accumulated out of the income of Trust 2, together with the income on such accumulations and also current undistributed income which would have been payable to Granddaughter 1, to the living issue per stirpes of Granddaughter 1.

Trust 2 shall terminate upon the death of the last survivor of Son, Granddaughter 1, Granddaughter 2, and Grandson. Son, Grandson, and Granddaughter 2 predeceased Granddaughter 1. Accordingly, Granddaughter 1 is the only survivor of the measuring lives of Trust 2. Upon Granddaughter 1's death, the trustee must

terminate Trust 2 and the trustee shall transfer, deliver and pay over the principal of Trust 2 to the persons who would otherwise have been entitled to the income therefrom, and in the same proportions.

Granddaughter 1, who is age x, has three children, A, B, and C. A, age a, and C, age c, have no children. B, age b, has two children, D, age d, and E, age e.

It has been represented that Trust 2 is exempt from GST tax because it was irrevocable on September 25, 1985, no corpus has been added to Trust 2 since September 25, 1985, and no modifications that would constitute additions have been made to Trust 2 since September 25, 1985. Trust 2 contains no restrictions (i.e. spendthrift clause) on a beneficiary or remainderman alienating his or her income or remainder interest. It has been represented that the trustee of Trust 2 has never made a distribution to Granddaughter 1 since her share was created.

On Date 2, Granddaughter 1 filed a petition in Court to terminate and distribute Trust 2 to Granddaughter 1 and the current and successor remaindermen according to their actuarially determined interests. Attached to the petition are the current and successor remaindermen's written consent to the termination. Furthermore, the current and successor remaindermen agree to guarantee and ensure the interests of each unborn contingent remainderman of Trust 2 and to provide accordingly in their respective estate planning documents.

Under State law, a court may decree the termination of a trust when all the objects and purposes of the trust which are inconsistent with the full beneficial ownership and control of the *cestui* are fulfilled, all the parties who are or may be beneficially interested in the trust property are in existence and *sui juris*, and they all consent and agree to the ending of the trust. The basis for such termination is that, because the beneficiary and remaindermen have the right to alienate their interests, there is no reason for the trust to continue. Citation.

On Date 3, Court issued an order that the share created for the benefit of Granddaughter 1 out of Trust 2 be terminated upon the receipt of a favorable private letter ruling from the Internal Revenue Service stating that termination of Granddaughter 1's Trust will not result in a generation-skipping transfer under section 2601 of the Internal Revenue Code or any other tax liability. Trustee is also directed to distribute Granddaughter 1's share to Granddaughter 1 and the current and successor remaindermen in accordance with each individual's actuarial interests therein, determined under section 7520 and based on the section 7520 interest rates in effect on the date the private letter ruling is issued.

You have requested the following rulings:

- 1) The proposed termination of Trust 2 will not cause the terminating distributions to be subject to GST tax.
- 2) The proposed termination of Trust 2 will not result in a transfer that is subject to the gift tax by any party to the termination.
- 3) The proposed termination of Trust 2 does not constitute a sale, exchange, or other disposition of property either by Trust 2 or any of the beneficiaries, in which any gain or loss is realized under sections 61 or 1001.
- 4) The income tax basis of the assets distributed to the beneficiaries on termination will be the same as the tax basis of Trust 2 in such assets.

Ruling 1

Section 2601 of the Internal Revenue Code imposes a tax on every generation skipping transfer, which is defined under section 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under section 1433(a) of the Tax Reform Act of 1986 (Act) and section 26.2601-1(a) of the Generation-Skipping Transfer Tax Regulations, the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under section 1433(b)(2)(A) of the Act and section 26.2601-1(b)(1)(i) of the regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, but only to the extent that such transfer is not made out of corpus added to the trust after September 25, 1985 (or out of income attributable to corpus so added). See section 26.2601-1(b)(1)(v) regarding constructive addition.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax will not cause the trust to lose its exempt status.

Section 26.2601-1(b)(4)(i)(D) provides that a modification of the governing instrument of an exempt trust (including a trustee distribution, settlement, or construction that does not satisfy section 26.2601-1(b)(4)(i)(A), (B), or (C)) by judicial reformation, or nonjudicial reformation that is valid under applicable state law, will not cause an exempt trust to be subject to the provisions of chapter 13, if the modification does not shift a beneficial interest in the trust to any beneficiary who occupies a lower generation (as defined in section 2651) than the person or persons who held the beneficial interest prior to the modification, and the modification does not extend the time for vesting of any beneficial interest in the trust beyond the period provided for in the original trust. A modification of an exempt trust will result in a shift in beneficial interest to a lower generation beneficiary if the modification can result in either an

increase in the amount of a generation-skipping transfer or the creation of a new generation-skipping transfer.

In the present case, Trust 2 was irrevocable on September 25, 1985. It is represented that no additions, actual or constructive, were made to Trust after that date. Based upon the facts submitted and the representations made we conclude that the proposed termination of Trust 2 will neither cause a beneficial interest to be shifted to a beneficiary who occupies a generation lower than the beneficiaries who held the interests prior to the termination, nor extend the time for vesting of any beneficial interest in Trust 2 beyond the period provided for in the original Trust 2. Accordingly, we rule that the proposed termination of Trust 2 will not cause the terminating distributions to be subject to the GST tax.

Ruling 2

Section 2501 imposes a tax for each calendar year on the transfer of property by gift during such calendar year by an individual. Section 2511 provides that the tax imposed by section 2501 shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that, if a gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. Section 2512(b) provides that where property is transferred for less than an adequate and full consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

Under section 25.2512-5 of the Gift Tax Regulations, in general, the fair market value of remainders transferred by gift is the present value of the remainders determined by use of the appropriate section 7520 actuarial factor.

Section 7520(a) provides that the value of an annuity, any interest for life or a term of years, or any remainder interest or reversionary interest shall be determined under tables prescribed by the Secretary, and by using an interest rate (rounded to the nearest two-tenths of one percent) equal to 120 percent of the federal midterm rate in effect under section 1274(d)(1) for the month in which the valuation date falls.

Pursuant to the proposed termination of Trust 2, the trustee shall distribute the assets in Trust 2 to Granddaughter 1 and the current and successor remaindermen according to their actuarially determined interests. Based upon the facts submitted and the representations made, we conclude that the proposed termination of Trust 2 will not result in a transfer that is subject to the gift tax by any party to the termination.

Rulings 3 and 4

Section 1015(b) provides that if property is acquired by a transfer in trust (other than by a transfer in trust by a gift, bequest, or devise), the basis shall be the same as it would be in the hands of the grantor increased in the amount of gain or decreased in the amount of loss recognized to the grantor on the transfer.

Section 1.1015-2(a)(2) of the Income Tax Regulations provides that the principles stated in section 1.1015-1(b) apply in determining the basis of property where more than one person acquires an interest in property by transfer in trust.

Section 1.1015-1(b) provides that property acquired by gift has a uniform basis, and that the proportionate parts of that basis represented by the interests of the life tenant and remainder interest holder are determined under rules provided in section 1.1014-5.

Section 1001(e)(1), however, provides that in determining gain or loss from the sale or disposition of a term interest in property, that portion of the adjusted basis of the interest which is determined pursuant to section 1015 (to the extent that the adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded. Under section 1001(e)(2), the "term interest in property" includes an income interest in a trust, but does not include a remainder interest. Section 1001(e)(3) provides that section 1001(e)(1) does not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons. See also section 1.1001-1(f).

Section 1222(3) provides that the term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than one year.

Section 1221(a) defines the term "capital asset" as property held by the taxpayer with certain listed exceptions not applicable here.

Section 1223(2) provides that in determining the period for which a taxpayer has held property however acquired there shall be included the period for which the property was held by any other person, if the property has the same basis in the taxpayer's hands as it would have in the hands of that other person.

Rev. Rul. 72-243, 1972-1 CB 233, provides that the proceeds received by the life tenant of a trust, in consideration for the transfer of the life tenant's entire interest in the trust to the holder of the remainder interest, are treated as an amount realized from the sale or exchange of a capital asset under section 1222. The right to income for life from a trust estate is a right in the estate itself. See McAllister v. Commissioner, 157 F.2d 235 (2d Cir. 1946), cert. denied, 330 US 826 (1947).

Although the proposed transaction takes the form of a distribution of the present values of the respective interests of Granddaughter 1, A, B, C, D, and E, in substance it

is a sale of Granddaughter 1, D and E's interests to A, B, and C, the remainder interest holders entitled to receive Trust 1 assets at termination under the terms of Trust 1. The amounts received by Granddaughter 1, D and E as a result of the termination of Trust 1 are amounts received from the sale or exchange of a capital asset. Rev. Rul. 72-243. Because Granddaughter 1's basis in the income interest of Trust 1 is a portion of the entire basis of the property under section 1015(b), and because the disposition of Granddaughter 1's term interest is not part of a transaction in which the entire interest in Trust 1 is transferred to a third party, Granddaughter 1's adjusted basis in Granddaughter 1's interest in Trust 1 is disregarded under section 1001(e). Granddaughter 1's holding period in the life interest in Trust 1 exceeds one year. Accordingly, under section 1222(3) the entire amount realized by Granddaughter 1 as a result of the early termination of Trust 1 will be long-term capital gain. D and E's holding period in their contingent remainder interests in Trust 1 also exceeds one year. Accordingly, under section 1222(3) the gain determined under section 1001(a) by D and E as a result of the early termination of Trust 1 will be long-term capital gain.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. This ruling is directed only to the taxpayers requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

In accordance with the power of attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Sincerely,

Lorraine E. Gardner
Senior Counsel, Branch 4
Office of Associate Chief Counsel
(Passthroughs & Special Industries)

Enclosures

Copy for section 6110 purposes